No. 75-1285

In the Supreme Court of the United States

OCTOBER TERM, 1975

Supreme Court, U. S.
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UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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No.

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINION BELOW

The opinion of the Court of Claims (App., *infra*, pp. 1a-60a), incorporating the opinion of the trial judge with minor changes and some additions, is reported at 524 F.2d 1155.

JURISDICTION

The judgment of the Court of Claims was entered

on October 22, 1975 (App., *infra*, pp. 1a, 60a).[1] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined by Section 801(c).

The question presented is whether an insurance company which assumed the ultimate insurance risk on accident and health insurance ceded to it by another company under a reinsurance agreement is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life insurance so as to render it ineligible for preferential tax treatment accorded to a "life insurance company," or whether, as the Court of Claims held, such reserves are attributable to the ceding company which temporarily holds the premiums paid in advance on such policies.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insur-

[1] The precise amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims.

ance Company Income Tax Act of 1959, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

(a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life in-

surance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801-3 *Definitions.*

* * * * *

(e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

§ 1.801-5 *Total reserves.*

* * * * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * * * *

STATEMENT

Respondent was incorporated under the laws of Missouri as a wholly-owned subsidiary of Aetna Finance Company, the assets of which are now owned by a wholly-owned subsidiary of International Telephone & Telegraph Corporation known as ITT Aetna Corporation (App., *infra*, p. 30a). Aetna made consumer loans through subsidiaries operating more than 200 finance company offices in approximately 25 states (App., *infra*, p. 3a). In connection with its loan transactions, it was common for Aetna's borrowers to apply for and receive credit life insurance policies (or group insurance certificates), including health and accident benefits, from one of three insurance companies: Old Republic Life Insurance Company, Pilot Life Insurance Company,

and National Fidelity Life Insurance Company (App., *infra*, pp. 3a-4a).

Under the life insurance provisions of these policies, the insurer was required to pay Aetna any outstanding balance of the loan in the event of the insured debtor's death. The accident and health (A&H) provisions of the policy required the insurer to pay loan installments falling due while the insured was totally disabled and unable to work. The terms of the policies were coextensive with the term of the related loan (App., *infra*, p. 4a).

A&H insurance was sold to Aetna's borrowers only together with life insurance. However, the amounts of the A&H insurance premiums were separately stated. The premiums were required to be paid in full by the insured debtor at the inception of the policy term (App., *infra*, pp. 33a, 39a-40a).

Respondent was organized by Aetna for the purpose of reinsuring the policies issued to Aetna's loan customers by Old Republic, Pilot, and National Fidelity. During 1963-1965, the taxable years at issue, respondent's business primarily consisted of such reinsurance. Respondent conducted its reinsurance business pursuant to reinsurance agreements ("treaties") with Old Republic, Pilot, and National Fidelity during each of the years in issue (App., *infra*, pp. 3a, 4a, 40a).

Under its reinsurance treaties with these companies, respondent assumed the entire insurance risk by agreeing to reinsure 100 percent of the liability of each company with respect to life insurance and A&H insurance issued to Aetna and its borrowers.

In exchange for assuming the insurance risk, respondent received the premiums less a 2 percent commission to the issuing companies.[2] The treaties provided for the payments of reinsurance premiums with respect to life insurance coverage as they were received by the issuing companies. However, the A&H insurance premiums were paid to respondent on a monthly basis and such payments represented that portion of the premiums allocable to the prior month's coverage (App., *infra*, pp. 4a-5a, 40).

Respondent was generally entitled to receive 98 percent of the premiums earned with respect to credit A&H insurance in force during the previous month. Thus, for example, if the issuing company received a $360 A&H premium on January 1, 1963, with respect to a 36-month policy, 1/36 of this premium ($10) would be allocable to coverage for the month of January and $9.80 would be paid over to respondent during the month of February (App., *infra*, pp. 5a, 40a-41a). Under the reinsurance treaties, respondent was liable to the issuing companies for the benefits covered by reinsurance to the same extent as the issuing companies were liable to the persons insured for such benefits. As a result, whenever a claim was made under a policy that the issuing company reinsured with respondent, respondent was required to consider it to be a claim for the full amount of reinsurance on the policy (App., *infra*, pp. 42a-43a).

For each of the years 1963, 1964, and 1965, respondent filed an annual statement with the Mis-

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[2] Old Republic retained an 11 percent commission (App., *infra*, p. 40a).

souri Division of Insurance. These annual statements did not reflect any unearned premium reserves with respect to policies issued by Old Republic, Pilot, and National Fidelity, or with respect to respondent's reinsurance treaties with those companies (App., *infra*, pp. 46a-47a). After audits of respondent by the Missouri Division of Insurance in 1965 and 1969, respondent was not required to establish unearned premium reserves with respect to A&H premiums received by Old Republic, Pilot, and National Fidelity, or with respect to reinsurance premiums received by respondent under its A&H reinsurance treaties with those companies (App., *infra*, pp. 47a-48a).

For each of its taxable years 1963, 1964, and 1965, respondent computed its taxable income on its federal income tax returns as a life insurance company under Section 802 of the Code. On audit, the Commissioner of Internal Revenue determined income tax deficiencies, asserting that respondent was not entitled to deduct certain losses in connection with the computation of its reserves (App., *infra*, pp. 8a, 57a). After respondent filed a petition in the Court of Claims seeking a refund of the deficiencies it paid, the Commissioner determined additional deficiencies for 1963, 1964, and 1965, based upon his conclusion that during those years respondent did not qualify for the preferential tax treatment accorded to a life insurance company. The ground of the Commissioner's determination was that respondent's life insurance reserves did not comprise more than 50 percent of its total reserves as required by Section 801(a) of the Code. The Commissioner's

determination was based upon his inclusion of the A&H reserves in respondent's total reserves (App., *infra*, pp. 8a, 57a-58a).

Respondent thereupon paid the additional deficiencies and sought its refund in the suit it had already commenced in the Court of Claims (App., *infra*, pp. 8a-9a).[3] With one judge dissenting, the Court of Claims adopted its trial judge's recommended decision that the A&H insurance reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because the various issuing companies were in physical possession of the unearned portion of the premiums paid in advance on the A&H policies under the reinsurance treaties (App., *infra*, pp. 13a-21a). The court concluded that respondent did not have to include the A&H insurance reserves as part of its total reserves because each monthly payment of A&H premiums made to respondent by the issuing companies represented premiums allocable to coverage for the prior month so they were not "unearned premiums" within the meaning of Section 801(c)(2) of the Code. In so holding, the court rejected the contrary conclusion on identical facts of the Seventh

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[3] The provisions of the Old Republic treaty differed from those of the Pilot and National Fidelity treaties as to the effect of termination upon insurance in force. In order to dispense with the need to consider the legal effect, if any, of such differences and because the A&H reserves with respect to the Old Republic treaty made no difference to the outcome of this case, the government agreed in the court below that they could be disregarded in computing respondent's total reserves (App., *infra*, p. 38a).

Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466, certiorari denied, 420 U.S. 947 (App., *infra*, pp. 13a-19a).

The court also ruled that respondent was not required by Missouri law to establish reserves for the disability insurance, so that they were not "other insurance reserves required by law" within the meaning of Section 801(c)(3) of the Code. Accordingly, the court held that respondent qualified as a "life insurance company" under Section 801(a) of the Code (App., *infra*, pp. 21a-22a).

The dissenting judge argued that the Seventh Circuit in *Economy Finance Corp.* v. *United States*, *supra*, construed Section 801(a) "in a sound and persuasive fashion" (App., *infra*, p. 28a). In this view, the A&H insurance reserves should be included in respondent's reserves as "unearned premiums" under Section 801(c)(2) of the Code because "it has arranged to have [such reserves] ostensibly carried for it by others, though in reality, it bears the risk of loss itself" (App., *infra*, p. 29a). In so concluding, the dissenting judge agreed with the conclusion of the Seventh Circuit in *Economy Finance* that non-inclusion of such reserves "completely frustrates the purpose Congress ha[d] in mind in prescribing the [50 percent] test [of Section 801(a)]" (App., *infra*, p. 29a).

REASONS FOR GRANTING THE WRIT

As the Court of Claims recognized here (App., *infra*, pp. 15a-19a), and in its companion decision

in *Consumer Life Insurance Co.* v. *United States*, 524 F.2d 1167, 1174, petition for a writ of certiorari pending, No. 75-1221, its holding directly conflicts with *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (C.A. 7), certiorari denied, 420 U.S. 947, which was followed in *First Railroad & Banking Co. of Ga.* v. *United States*, 514 F.2d 675 (C.A. 5). See also *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4). The decision below holding that an insurance company is not required to include in its total reserves those reserves attributable to non-life insurance on which it bears the ultimate insurance risk so that it may qualify for the preferential tax treatment accorded to a "life insurance company" as defined in Section 801(a) of the Internal Revenue Code of 1954, is therefore in conflict with those of two courts of appeals. The issue has substantial impact upon the revenue and has been and continues to be widely litigated. Resolution of the conflict by this Court is therefore essential in order that there be a uniform national rule.

For the reasons we have set forth at pp. 14-21 in our petition for a writ of certiorari in *Consumer Life Insurance Co.* v. *United States*, *supra*,[4] we submit that the economic substance of respondent's reinsurance arrangement, which is typical of those used in the industry, decisively establishes that the A&H reserves are includable in respondent's total reserves as "unearned premiums" under Section 801

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[4] We are serving a copy of our petition in *Consumer Life Insurance Co.* upon counsel for the respondent.

(c)(2). As the Seventh Circuit stated in its contrary decision in *Economy Finance Corp.* v. *United States*, *supra*, in characterizing the role of a company analogous to that of Old Republic, Pilot, and National Fidelity in an arrangement virtually identical to respondent's reinsurance treaty: "[it] performed a banking and clearing-house function and not an insurance function" (501 F.2d at 478). Similarly, the three ceding companies in this case were exposed to no insurance risk and therefore cannot be deemed to have any insurance reserves. The A&H reserves must therefore be included in respondent's total reserves under Section 801(c)(2).[5]

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[5] The Court of Claims' conclusion (App., *infra*, pp. 21a-22a) that respondent was not required under Missouri law to establish a reserve for the A&H insurance does not detract from our argument that the economic reality of the reinsurance arrangement is controlling for federal tax purposes under Section 801(c)(2). See p. 21, n. 7, of our petition for a writ of certiorari in *Consumer Life Insurance Co.*, No. 75-1221.

At all events, we submit that the Court of Claims erred in concluding that Missouri law did not require respondent to establish a reserve for the A&H insurance. In so concluding, the Court of Claims did not undertake an independent analysis of the state statute but premised its conclusion upon the fact that the Missouri insurance administrators did not require respondent to establish reserves with respect to the A&H insurance (App., *infra*, pp. 22a, n. 4, 48a-49a). But under the Missouri statute, Vernon's Ann. Mo. Stat. § 376.410 (1968), the ceding companies were exempt from carrying reserves on the A&H insurance, so that respondent should have established such reserves. Thus, the A&H reserves would be includable in respondent's total reserves on the independent alternative ground that they were "other insurance reserves required by law" under Section 801(c)(3) of the Code. See also Treasury Regulations (26 C.F.R.), Section 1.801-5(b).

CONCLUSION

For the reasons stated above and in our petition in *Consumer Life Insurance Co.*, the petition for a writ of certiorari should be granted.[6]

Respectfully submitted.

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Solicitor General.

SCOTT P. CRAMPTON,
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Attorneys.

MARCH 1976.

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[6] The Court may deem it appropriate to hold this case pending its disposition of *Consumer Life Insurance Co.* The two reinsurance arrangements of that case are respectively identical to those considered by the conflicting decisions of the Seventh and Fifth Circuits in *Economy Finance Corp.* and *First Railroad & Banking Co. of Ga.* However, the reinsurance treaty in this case corresponds to the arrangement considered in *Economy Finance Corp.*

APPENDIX

IN THE UNITED STATES COURT OF CLAIMS

No. 109-68

(Decided October 22, 1975)

PENN SECURITY LIFE INSURANCE COMPANY

v.

THE UNITED STATES

John B. Jones, Jr., for plaintiff; *Owen T. Armstrong*, attorney of record. *Lowenhaupt, Chasnoff, Freeman, Holland & Mellitz, Robert A. Kagan, John T. Sapienza, Andrew W. Singer*, and *Covington & Burling*, of counsel.

Herbert Grossman, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Gilbert E. Andrews* and *Roger A. Schwartz*, of counsel.

Before COWEN, *Chief Judge*, DAVIS, NICHOLS, SKELTON, KASHIWA, KUNZIG, and BENNETT, *Judges*.

PER CURIAM:* Section 801(a) of the Internal

* This opinion incorporates the opinion of Trial Judge Lloyd Fletcher, with minor changes and some additions.

Revenue Code, as amended, defines a life insurance company in the following language:

> (a) Life Insurance Company Defined.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,
>
> comprise more than 50 percent of its total reserves (as defined in subsection (c)).[1]

In *Alinco Life Insurance Company* v. *United States*, 178 Ct. Cl. 813, 373 F. 2d 336 (1967), the court addressed its attention to the question of whether an insurance company specializing in the reinsuring of *credit life* insurance could qualify as

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[1] Section 801 goes on to provide:

* * * * *

"(c) *Total Reserves Defined.*—For purposes of subsection (a), the term 'total reserves' means—

(1) life insurance reserves.

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

"The term 'total reserves' does not include deficiency reserves (within the meaning of subsection (b) (4))."

a life insurance company under Section 801, and held that it could, provided it met the 50 percent test. As might have been easily predicted, the question of life insurance company qualification is now back before the court with emphasis, however, on those provisions of Section 801 dealing, not with life insurance, but with health and accident insurance. In applying Section 801 to this case, we appreciate that the statute was *not* "written for ordinary folk * * *." It is addressed to technical specialists (*i.e.*, actuaries) and hence, its provisions "must be read by judges with the minds of the specialists." Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COL. L. REV. 527, 536 (1947).

On balance, we have concluded that plaintiff-taxpayer has the better of the argument and qualifies as a life insurance company so that it is entitled to recover. To explain why requires, first of all, a description of the taxpayer's method of conducting its insurance business during the years in issue, namely, the calendar years 1963, 1964, and 1965.

In those years, plaintiff's business consisted primarily of reinsuring risks written by three unrelated insurance companies under credit life, accident and health policies on the lives and health of debtors of plaintiff's parent, Aetna Finance Company (Aetna). Aetna was engaged in the business of making consumer loans through subsidiaries operating over 200 finance company offices in approximately 25 states.

In connection with such loan transactions, it was commonplace for Aetna's borrowers to apply for

and receive credit life insurance policies (or group insurance certificates), including health and accident benefits, from one of three insurance companies, namely, Old Republic Life Insurance Company (Old Republic), Pilot Life Insurance Company (Pilot), and National Fidelity Life Insurance Company (National Fidelity). Hereafter, these companies are frequently referred to as "the ceding companies," and plaintiff had separate disability reinsurance treaties in force with each of them during the years involved.

Under the life insurance provisions of these policies, the insurer was required to pay the creditor any outstanding balance of the debt in the event of the insured debtor's death. The health and accident provisions called for the insurer to pay debt installments falling due while the insured was totally disabled and unable to work. The terms of the policies (or group certificates) were coextensive with the contractual term of the related indebtness, usually two to three years.

Under its reinsurance treaties with the ceding companies, plaintiff agreed to reinsure 100 percent of the liability of each ceding company with respect to disability benefits included in credit life policies issued to Aetna and its borrowers. These treaties provided for payment of reinsurance premiums to plaintiff on a monthly earned premium basis; *i.e.*, a reinsurance premium was payable each month with respect to reinsurance coverage provided during the previous month based on a percentage of premiums "earned" on covered policies during that month.

All of the credit insurance policies issued by the ceding companies called for payment of insurance premiums (both a life insurance premium and, where applicable, a disability premium) at the inception of the policy term. When a disability premium is first received under such a policy, it is wholly "unearned" in the sense that the entire premium is attributable to the unexpired portion of the policy. As the term of the policy expires each month, a proportionate part of the premium becomes "earned"; *i.e.*, attributable to insurance protection provided during that month.

Thus, to use plaintiff's illustration, if a ceding company received a $360 disability premium on January 1, 1963, with respect to a policy providing insurance coverage for 36 months, one-thirty-sixth of this premium (or $10) would be considered "earned" during the month of January and each succeeding month. The "unearned" premium would be $350 at the end of January, $340 at the end of February, and so on. Under its disability reinsurance treaties, plaintiff was entitled to a monthly reinsurance premium equal to a percentage of the $10 "earned" premium for reinsurance coverage actually provided each month. The ceding companies retained all unearned premiums on policies covered under the disability reinsurance treaties and established an unearned premium reserve in the amount of such unearned premiums for the benefit of their policyholders in accordance with the applicable restrictions of state law and in satisfaction of the reserve require-

ments of the various states in which they did business.

Since plaintiff received no unearned premiums from the ceding companies, it was not required to establish an unearned premium reserve by the State of Missouri. No actuary or state regulatory authority required plaintiff to establish an unearned premium reserve under its disability reinsurance treaties with the ceding companies, since plaintiff never received premiums thereunder for insurance to be provided in the future or premiums which it might otherwise be required to refund.

Approximately two-thirds of the unearned premium reserves held by the ceding companies represented unearned "loading" charges made to cover profits and sales and office expenses. The remaining one-third of such unearned premium reserves represented unearned *net* premiums charged to policyholders to cover the expected cost of providing disability insurance benefits; this portion alone (known in the industry as the morbidity element) reflected the amount that the companies were actuarially required to hold in order to pay disability claims as they matured. Unearned loading charges are held as part of unearned premium reserves because the casualty insurance industry has traditionally determined its reserve requirements with regard to the full amount of premiums that would have to be refunded if all policies in force were simultaneously canceled instead of reserving only for the cost of carrying the insurance risk (the unearned *net* premiums) as in life insurance.

As insureds grow older, the mortality or morbidity costs increase and when an accident and health policy is written for a long term of years, the guaranteed level premium charged will not be sufficient to provide benefits after the insured reaches a specified age. In those instances, a reserve, in addition to the pro rata gross unearned premium reserve, is set up out of current premiums to provide for the excess of future benefits over future premiums. No such reserves were created by the three insurers with regard to the credit accident and health policies reinsured with taxpayer, presumably because such policies were relatively short-term.

In addition to its reinsurance treaties with the ceding companies during the years in issue, plaintiff also issued its own group annuity policy on December 22, 1965 (Group Annuity Contract No. 101) to the St. Louis Union Trust Company as trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees, which contract has remained outstanding and in effect to the present time. Plaintiff received securities valued at $5,929,057.24 for the purchase of single premium annuities under Group Annuity Contract No. 101 on or about December 22, 1965. Prior to this transaction, no group annuity or individual annuity contracts had been purchased by any trustee of any pension fund under the International Telephone Retirement Plan for Salaried Employees on the lives of the individuals covered under Group Annuity Contract No. 101.

Plaintiff maintained a reserve of $6,072,004 on December 31, 1965, with respect to its liabilities under Group Annuity Contract No. 101 on that date. Such reserve was computed on the basis of a recognized mortality table (1959 G.A.) and an assumed rate of interest (3½%), and was set aside to mature or liquidate future unaccrued claims arising under Group Annuity Contract No. 101.

On April 4, 1968, plaintiff filed a petition with this court seeking a refund of income taxes for the years in issue on the grounds, *inter alia*, that it was entitled to deduct accrued and unpaid losses under Section 809(d)(1) of the Code and to take such losses into account in determining the increase in its reserves for those years as provided in Section 809(d)(2) of the Code. On October 24, 1968, a notice of deficiency was mailed to plaintiff with respect to the years covered in plaintiff's petition. The deficiencies proposed therein were based upon the assertion that plaintiff did not qualify as a life insurance company during the years 1963, 1964, and 1965 under Section 801(a) of the Code, and upon that assertion, by an Amended Answer, defendant filed a counterclaim herein.

On February 14, 1969, after the time provided by statute for petitioning the Tax Court had expired but while plaintiff's tax liability for the years covered by the notice of deficiency was still before this court, the Commissioner of Internal Revenue assessed the amount of the asserted deficiencies in plaintiff's income tax, together with interest on such deficiencies, and demanded payment thereof. Plaintiff contested

the validity of this assessment, but paid such amounts under protest on March 5, 1969. On March 30, 1970, plaintiff filed its First Amended Petition with this court seeking recovery of the amounts claimed in its original petition as well as the amounts of the asserted deficiencies paid on March 5, 1969. In its Answer to plaintiff's First Amended Petition, defendant stated that "since the Plaintiff has paid the taxes for which the counterclaim was filed and amended its petition to include a claim for refund for these taxes, a counterclaim by the defendant is no longer necessary, nor required by law."

Plaintiff attacks the validity of the assessment described in the preceding paragraph. The argument is that, at a time when plaintiff had a refund suit pending in this court for the years 1963, 1964, and 1965, defendant determined additional deficiencies for those same years thus bringing into play the provisions of Section 7422(e) of the Internal Revenue Code. In pertinent part, that section reads as follows:

> (e) Stay of proceedings.—If the Secretary or his delegate prior to the hearing of a suit brought by a taxpayer in a district court or the Court of Claims for the recovery of any income tax, * * * mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter. If the taxpayer files a petition with

> the Tax Court, the district court or the Court of Claims, as the case may be, shall lose jurisdiction of taxpayer's suit to whatever extent jurisdiction is acquired by the Tax Court of the subject matter of taxpayer's suit for refund. If the taxpayer does not file a petition with the Tax Court for a redetermination of the asserted deficiency, the United States may counterclaim in the taxpayer's suit, * * * within the period of the stay of proceedings notwithstanding that the time for such pleading may have otherwise expired. The taxpayer shall have the burden of proof with respect to the issues raised by such counterclaim * * * of the United States except as to the issue of whether the taxpayer has been guilty of fraud with intent to evade tax.

Plaintiff asserts that the procedure prescribed in Section 7422(e) invalidates the assessment described above because the section must be read as calling exclusively for a counterclaim. While the argument is an ingenious one, we find it without merit.

First of all, it overlooks the permissive, as opposed to mandatory, wording of Section 7422(e) which merely states that the Government "may counterclaim in the taxpayer's suit." The effect of such language is explained in *Bar L Ranch, Inc.* v. *Phinney*, 400 F.2d 90, 92 (5th Cir. 1968) as follows:

> In Flora v. United States, 1958, 362 U.S. 145, 80 S.Ct. 630, 4 L. Ed.2d 623, the Supreme Court explained that when a taxpayer chooses to remain in the district court in a case similar to the instant case, "the Government may—but seemingly is not required to—bring a counter-

> claim; and if it does, the taxpayer has the burden of proof." This language indicates that the counterclaim is a permissive one, and that other methods may be used for the collection of the tax. Thus the Court assumed that any assessment of the tax would be valid since a separate collection suit would have to be based on a valid assessment. See also Florida v. United States, 8th Cir. 1960, 285 F.2d 596.

The Circuit Court then went on to hold that an assessment, in essence similar to the one disputed here, was valid.

Secondly, plaintiff apparently would ignore the limitations provisions contained in Section 6501 of the Code. That section requires the Government to assess "within 3 years after the return was filed * * *." By Section 6501(c)(4) that period may be extended by mutual consent of the taxpayer and the Government, a procedure presumably well known to the able and sophisticated tax counsel for this plaintiff. No effort is made to explain why this was not done in the present case.

However, lastly and in all events, the decision for plaintiff on the merits, as below, would seem to render this procedural point moot.

The Section 801 Issue

Turning to the merits, it is necessary at the outset to determine whether plaintiff, under Section 801 of the Internal Revenue Code, qualifies for taxation as a life insurance company. As was pointed out in *Alinco*, *supra* at 838, 373 F.2d at 350, the

qualification formula in Section 801 may be expressed in terms of the following fraction, the quotient of which must be more than 50 percent in order for an insurance company to qualify as a life insurance company:

Qualifying reserves (numerator)	÷	Total reserves (denominator)
1. Tabular reserves on life, annuity, and noncancellable accident and health policies		1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on noncancellable life, health, or accident policies not included in (1)		2. Unearned premiums not included in (1)
3. Unpaid losses on non cancellable life, health, or accident policies not included in (1)		3. Unpaid losses not included in (1)
		4. All other insurance reserves required by law.

If one goes no further than plaintiff's own books and records, it is clear from the figures set out in finding 14, *infra*, that plaintiff's quotient (or reserve test ratio, it is frequently called) exceeded 50 percent in each taxable year. Defendant does go further, however. Using a process somewhat reminiscent of a Section 482 allocation of income between related corporations, defendant would allocate or, to use its word, attribute to plaintiff the unearned premium reserves of the ceding companies established by them with respect to their disability policies reinsured by plaintiff. Defendant justifies this attribution upon the theory that reserves must follow the risk and, by increasing the denominator of the above fraction, the effect is to decrease plaintiff's reserve test ratio below 50 percent in each year.

Plaintiff, of course, objects vigorously to this attribution to it from unrelated companies of unearned premium reserves which it was not required to hold, had no right to hold, and did not in fact hold. It points out that, under its reinsurance treaties with the ceding companies, plaintiff neither received nor had any right to receive "unearned premiums" as that term is defined in Treas. Reg. Section 1.801-3 (e),[2] because those treaties provided that the monthly reinsurance premiums were payable only *after* they had been earned by plaintiff, not in advance. Plaintiff is correct in these contentions.

Presented with a credit reinsurance arrangement essentially identical to the present case, the U.S. District Court for the Southern District of Indiana held for the taxpayer. *Economy Finance Corp.* v. *United States*, 30 AFTR 2d 72-5446 (July 25, 1972), rev'd. 501 F.2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975). There, as here, the Government sought to disqualify from life insurance company status reinsurers by adding "unearned premiums" held by a ceding company to their "total reserves." Again like the present case, the reinsurance treaties provided for payment of the reinsurance of credit accident and health risks on a monthly earned premium basis. The District Court found that such "reinsurance on a month-to-month basis is not an uncommon or un-

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[2] The regulation states that the term "means those amounts which shall cover the cost of carrying the insurance risk *for the period for which the premiums have been paid in advance* * * *." (Emphasis supplied.)

accepted reinsurance arrangement" and in a comprehensive and well-reasoned opinion refused to attribute the ceding company's unearned premium reserves to the reinsurer. 30 AFTR 2d at 72-5451. In this respect, the court found the mode of premium payment conclusive, saying:

> * * * An unearned premium reserve is required to be established only with respect to that portion of the premium (or reinsurance premium) which has been received by the insurance company prior to the expiration of the period of coverage to which that premium relates. An insurance company is not required to establish an unearned premium reserve with respect to premiums or reinsurance premiums to be received in the future. Since under the terms of the accident and health Reinsurance Treaties reinsurance premiums were due from Standard Life to National Life and United Life only in the month succeeding the month for which the two reinsurers assumed the risk on the credit accident and health insurance policies issued by Standard Life, those reinsurance premiums were fully earned when received. It therefore would have been improper for National Life or United Life to establish any unearned premium reserve. Since National Life and United Life received only reinsurance premiums which represented payments for the assumption of insurance risks by those companies which had already expired by each reserve date, they were not required to set up unearned premium reserves. No state regulatory agency would have required National Life or United Life to set up unearned premium

> reserves with respect to the credit accident and health insurance which was issued by Standard Life and reinsured by National Life and United Life. Even without the cancellation provisions in the credit accident and health Reinsurance Treaties, it would not have been proper for National Life or United Life to set up unearned premium reserves since under the terms of those treaties they reinsured risks on a month-to-month basis. Since under the terms of the credit accident and health Reinsurance Treaties National Life or United Life were given the right to cancel the treaties upon giving 30 days' notice, in which event they would have been subject to only a limited amount of liability on policies then in force, an additional reason exists for their not being required to establish unearned premium reserves.

30 AFTR 2d at 72-5452.

We agree with the District Court's reasoning and result. The Seventh Circuit reversed the District Court but we cannot accept the rationale of the majority of the Court of Appeals. It should be noted, first, that the facts in *Economy Finance Corporation* differed from those in the present case in one important respect. Those taxpayers had agreements with the ceding company under which the latter was required to invest most of the unearned premium reserves in subordinated debentures of the parent of one of the taxpayers, and then to turn over the interest income received on those debentures as an "additional commission" to the insurance agency partnership composed of stockholders of one of the related taxpayers. *See* 501 F.2d at 470. Thus, the

Economy Finance taxpayers in effect received the proceeds of the unearned reserves even while in the hands of the ceding company. That arrangement was quite different from the one involved in the case at bar and could be understood as making that ceding company the agent of those taxpayers.

But the Court of Appeals, though it referred to that side-arrangement (*see* 501 F.2d at 471 n. 5, 477), did not center its decision thereon. Recognizing that the literal terms of § 801 favor the taxpayer (501 F.2d at 477), the Court of Appeals refused to apply the statute as written because, in its view, that interpretation failed to further Congress's purpose in giving special tax treatment to life insurance companies. That dominant objective the Seventh Circuit took to be the legislative desire to postpone half of the tax on investment income which accrues with respect to much life insurance and which cannot be accurately determined "until the life contract has been completely performed." *See* 501 F.2d at 474, 476-77. Since such investment income is not a factor for the health and accident policies involved in *Economy Finance* and here, the court considered that it would distort the Congressional purpose to allow those policies to be taken into account (without offsetting reserves) in determining whether the companies are entitled to "life insurance company" treatment.

We are far less certain than the Seventh Circuit that this was Congress's overriding aim. Section 801 is a technical provision, carefully worked out in some

detail over the years. As Circuit Judge Stevens pointed out in dissent in the *Economy Finance* case, Congress could have differentiated "life insurance companies" from others for tax purposes by selecting any of a number of measuring rods, but it chose a simple reserve-ratio test which has the advantage of being hinged to the requirements of state authorities as to the maintenance of adequate reserves, 501 F.2d at 483. The legislative history does not indicate that Congress zeroed in on policies connected with under writing income. Indeed, the reserve-ratio criterion was initially selected by Congress decades before the enactment of the current provisions for deferring part of the underwriting gain, at a time when Congress viewed premium receipts as not taxable because not true income but rather as analogous to permanent capital investment. *See Helvering* v. *Oregon Mutual Life Ins. Co.*, 311 U.S. 267, 268-69 (1940); *Alinco Life Ins. Co.* v. *United States*, *supra* at 831, 373 F.2d at 346. Moreover, Congress imposed statutory limits on the amount of deferrable underwriting income (*see* § 815(d)(4)), and there is no certainty that a company qualified as a "life insurance company" would be able to take full advantage of that privilege, perhaps not at all.

Still another indication, in our view, that Congress probably did not intend to restrict the concept of "life insurance company" to those firms having a predominance of policies yielding deferrable underwriting income is the Code's treatment of "modified coinsurance." In that situation the ceding com-

pany holds the reserves on reinsured risks, but also pays over the investment income from the reserve to the reinsurer. Congress has provided in § 820 that the reinsurer may, though it need not, take the ceding company's reserve into account but only if both parties consent to this treatment. *See also* Rev. Rul. 70-508, 1970-2 C.B. 136. As taxpayer points out, this would result in the anomaly, under the Seventh Circuit's opinion, that a reinsurer may successfully avoid attribution if it has the ceding company pay over gross investment income from the reserve, but must accept attribution when the ceding company not only holds the reserve but keeps the investment income. Defendant's response is that § 820 does not relate to qualification as a "life insurance company" but only to the determination of taxable-investment income and gain, once qualification has been established. This is true but does not destroy the point that it is doubtful that Congress gave special treatment to life insurance companies primarily because of their underwriting income.

In addition, the consequences of the general rule laid down by the Court of Appeals are uncertain and unclear. Judge Stevens thought the majority's standard might well exclude from coverage under § 801 such a common form of life insurance as term insurance. *See* 501 F.2d at 486 n.7. There may be other untoward gaps or disharmonies. We cannot tell because the consequences of departing from the text of § 801 are opaque.

In these circumstances, it seems to us preferable to accept the statute as written, leaving to Congress

the function of closing loopholes (if they exist) or restructuring the provision in greater detail. The section is technical and specific, directed to a complicated but very narrow segment of the law. If there be some anomalies under the statute as it stands, the Congress is in far better position to clarify its purpose and to harmonize § 801 with the other provisions of the insurance portion of the Code. Though there may be some results which can be questioned on economic or actuarial grounds, the literal words of the section do not produce absurd results, or results which one can say are clearly contrary to the legislative purpose. *Cf. United States* v. *Olympic Radio & Television Co.*, 349 U.S. 232, 236 (1955). We agree therefore with Circuit Judge Stevens, dissenting in *Economy Finance* (501 F.2d at 485): "* * * the government's conclusion that life insurance represents less than half of taxpayers' total insurance business rests on a non-statutory standard. Congress may have acted unwisely in giving preferential tax treatment to life insurance companies, and it may have been unwise to select a reserve-ratio test as the definition of a life insurance company for tax purposes. Nevertheless, we must, of course, apply the test which Congress has specified."

Defendant also urges that a different result is called for by a recent decision by the Fourth Circuit Court of Appeals in *Superior Life Insurance Company* v. *United States*, 462 F.2d 945 (4th Cir. 1972). In our view, defendant's reliance on that case is entirely misplaced. *Superior Life* did not involve rein-

surance. The unearned premiums there involved were collected and held by the taxpayer's parent company (a finance company, not an insurer) under a group insurance policy issued by the taxpayer. The parent acted merely as the taxpayer's agent and "in reality the fund in [the parent's] hands was subject to being used to pay taxpayer's obligations and for the benefit of taxpayer whenever taxpayer so desired." *See Superior Life Ins. Co.* v. *United States*, *supra*, at 950. None of the facts on which the decision in *Superior Life* turned—(1) the agency relationship between the holder of the premiums and the insurance company, (2) the free availability of the unearned premiums to the insurance company, and (3) identity of control between the parent-agent and subsidiary-insurance company—is present here. Since the taxpayer in *Superior Life* "constructively received" unearned premiums under long-accepted principles of tax law, the Fourth Circuit's decision is entirely consistent with the fact that the existence of unearned premium depends upon the mode of premium payment.

On this phase of the case, mention should be made of plaintiff's argument that defendant's "reserves follow the risk" rule has been recently rejected by this court in *Title Guarantee Co.* v. *United States*, 193 Ct. Cl. 1, 432 F.2d 1363 (1970). Defendant continues to urge, however, that the earlier decision of *Colonial Surety Co.* v. *United States*, 147 Ct. Cl. 643, 178 F. Supp. 600 (1959), established a "reserves follow the risk" rule for tax purposes. But in

Title Guarantee the court rejected that argument and distinguished the *Colonial Surety* case as follows:

> * * * The plaintiff [in the *Colonial Surety* case] sought to deduct *unearned commissions and not unearned premiums.* * * *
>
> The government argues that the portion of the trust fund attributable to the parts of the policies reinsured should not be considered as unearned premiums * * * for the reason that the taxpayer is no longer carrying the risk on the parts reinsured. *We cannot accept this theory.* Even though plaintiff has obtained reinsurance, it is still liable to the policyholder in case of loss and is, therefore, still carrying the risk despite the reinsurance.

Title Guarantee Co. v. *United States, supra,* 193 Ct. Cl. at 25, 432 F.2d at 1376. (emphasis added).

Finally, at a later stage in this litigation the court itself injected an issue which had not been presented to the trial judge or to the three-judge panel of the court which first heard the argument. As a result of the decision by a different trial judge in *Consumer Life Ins. Co.* v. *United States,* No. 463-70, the court ordered the parties to brief and argue the question of whether *state law* required the taxpayer to establish an insurance reserve for the unearned premiums involved here (if so the case would be governed by Section 801(c)(3), *supra* note 1, and the taxpayer would lose). The case was then ordered to be heard en banc.[3] It has since been held awaiting

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[3] This was done before the three-judge panel had rendered its decision.

the decision in *Consumer Life Ins. Co.* which was argued somewhat later. That case is also being decided today, and on the new issue of the requirements of state law we dispose of this case on the reasoning of the court's opinion in *Consumer Life*—Missouri law did not require taxpayer to establish reserves for the premiums involved here.[4]

From all the foregoing, it is concluded that defendant's attempt to attribute to plaintiff the unearned premiums reserves actually held by the ceding companies is incorrect. Accordingly, plaintiff's reserve test ratio for 1963 was 68.50 percent, for 1964 was 54.48 percent, and for 1965 was 85.76 percent. *See* finding 14, *infra.* Therefore, plaintiff qualified in those years as a life insurance company under Section 801, and it is unnecessary to reach alternative arguments made by counsel for the parties.

Plaintiff's Group Annuity Policy No. 101

On December 22, 1965, plaintiff issued its own group annuity policy No. 101 to the St. Louis Union Trust Co. as trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees. At December 31, 1965, plaintiffs reserve

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[4] *See* Findings of Fact 19, 20, 21, 22, 28, and especially 29 *infra.* Defendant relies mainly on *Vernon's Annotated Missouri Statutes* § 376.410(1), (3), and (4), but the text of those provisions fully harmonizes with the interpretation of Missouri law spelled out in our findings and followed by the Missouri insurance administrators, *i.e.*, that Missouri law did not during the years in question require this taxpayer to set up the reserves in question.

held with respect to annuities purchased under this policy was $6,072,004. In computing the amount of its reserves under Section 801(b)(5) which requires life insurance companies to use the mean of reserves held at the beginning and end of the year, plaintiff included $3,036,002 (0+$6,072,004÷2) with respect to this annuity policy.

Defendant recomputed the annuity reserves under Section 806(a) by adjusting them on a daily basis. This adjustment was accomplished by applying a fraction to the reserve, the numerator of which was the number of days during the year in which the reserve was held and the denominator of which was the number of days in the year, and the result was to reduce plaintiff's year-end reserve to $502,156. Claiming this adjustment to be entirely erroneous, plaintiff asserts that neither the language nor the purpose of Section 806(a) covers reserves held under a newly issued policy by the original insurer, as was the case of Annuity Policy No. 101. Section 806(a) reads:

> For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the assets, shall be approximately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

Plaintiff argues that this section was designed by Congress exclusively to deal with acquisitions of reserves by one insurance company from another insurance company in those cases (commonly referred to as "assumption reinsurance") where the acquiring company becomes solely liable in place of the transferor company on the insurance contracts under which the acquired reserves are held. Clearly this did not occur in the present case, and the argument is that, therefore, Section 806(a) cannot apply but instead the more general averaging provisions of Section 801(b)(5) govern.

From the admittedly rather sparse legislative history, plaintiff would seem to be correct in this contention. For example, the following appears in S. Rep. No. 291, 86th Cong., 1st Sess. 51 (1959) (1959-2 C.B. 807):

> * * * Subsection (a) of your committee's new section 806 relates to situations where there is a change in life insurance reserves (either increases or decreases) attributable to the transfer of liabilities under contracts taken into account in computing such reserves. This occurs, for example, when life insurance company I purchases all or a part of the business of life insurance company X under an arrangement (sometimes referred to as "assumption reinsurance") whereby company I becomes solely liable to the policy holders. Both I and X will have to make the adjustments provided by subsection (a).

The illustration which follows the above excerpt, as well as the examples given in Treas. Reg. Section

1.806-3(a), all deal with transactions and transfers between insurance companies.

Defendant agrees that the examples cited all illustrate transfers between insurance companies but counters with the observation that the regulations and Committee Reports do not specifically limit the section in the manner contended for by plaint. and points to the language of the statute which covers transfers "between the taxpayer and *another person.*" (emphasis supplied.) If Congress intended to limit the applicability of Section 806(a) to transfers between insurance companies, defendant suggests it would have used the phrase "insurance company" instead of the word "person." This is an appealing argument, but, in our view, it is clearly offset by plaintiff's rational rejoinder that Congress used the term "person" with a view to reaching all acquisitions of reserves under *pre-existing insurance* contracts, including those in which the transferor may not qualify as an insurance company for *tax purposes,* and not to require a special adjustment of reserves when a *new* policy is issued to the trustee of a pension plan, such as St. Louis Union Trust Co.

Plaintiff also seems on sound ground in contending that the inapplicability of Section 806(a) to the issuance of a new insurance contract is manifest in defendant's inability to show here any "liabilities" on the part of the transferor, any "transfer" of such "liabilities," and any reserves computed on the basis of the transferor's "liabilities." It is not disputed that under the IT&T pension plan the employer had

no liability for the payment of benefits nor that under the trust agreement the trustee was not liable for losses other than those resulting from its own neglect.

Nonetheless, says defendant, their fiduciary duties and obligations under the plan constituted "essentially an insurance function." However, as plaintiff observes, this misconceives the nature of the fiduciary relationship. It is hornbook law that a trustee is not an insurer but at most has the responsibility prudently to manage the trust funds in accordance with the purpose set forth in the trust instrument. *See* 3 SCOTT on TRUSTS § 204 (3d ed. 1967).

Finally, it can hardly be disputed that the annuity reserves in question were established as a result of liabilities incurred by plaintiff under its annuity policy No. 101 and were not attributable to "liabilities" assumed by plaintiff under the pension plan or the trust agreement. Hence, Section 806(a) does not apply.

The Unpaid Losses Deduction Issue

It is not disputed that in computing its "gain from operations" as defined in Section 809(b), plaintiff was entitled to a deduction under Section 809(d)(1) for accrued and unpaid losses of $120,596 in 1963, $55,605 in 1964, and $30,000 in 1965. The present problem arises because plaintiff asks to deduct them again under Section 809(d)(2) which allows a deduction for an increase in certain reserves, including the reserve for unpaid losses. If this were per-

mitted, the Government contends that the same item would be deducted twice in violation of Section 818 (f) which reads:

> (f) *Denial of double deductions.*—Nothing in this part shall permit the same item to be deducted more than once under subpart B and once under subpart C.

The Government also points to Treas. Reg. Section 1.809-5(b) which expressly bars the double deduction of unpaid losses and an increase in unpaid loss reserves in the following language:

> (b) *Denial of double deduction.* Nothing in section 809(d) shall permit the same item to be deducted more than once in determining gain or loss from operations. For example, if an item is allowed as a deduction for the taxable year by reason of its being a loss incurred within such taxable year (whether or not ascertained) under section 809(d)(1), such item, or any portion thereof, shall not also be allowed as a deduction for such taxable year under section 809(d)(2).

There can simply be no doubt that the example given in the above regulation specifically proscribes the 809(d)(2) deduction here claimed by plaintiff. Therefore, to hold for plaintiff would necessarily require a determination that the regulation is invalid, and such a determination is not permissible in our view.

Plaintiff has made no showing that the departmental construction exemplified in this regulation is so unreasonable as to require a holding of invalidity,

and long ago the Supreme Court had the following to say in *Boske* v. *Comingore*, 177 U.S. 459 at 470 (1900):

> Those who insist that * * * a regulation is invalid must make its invalidity so manifest that the court has no choice except to hold that the Secretary has exceeded his authority and employed means that are not at all appropriate to the end specified in the act of Congress.

Plaintiff's heavy reliance on *Title Guarantee, supra,* is misplaced, for there the court was not confronted with the necessity of holding a regulation invalid. Hence, as to this issue it is our view that the Government's position is correct.

Since, however, plaintiff should prevail on other remaining issues, as discussed above, it is entitled to recover with the amount thereof to be determined in further proceedings under Rule 131(c).

NICHOLS, *Judge*, dissenting:

Upon a careful reading of *Economy Finance Corp.* v. *United States*, 501 F. 2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), I find it applies the text in IRC § 801(a), defining a Life Insurance Company in a sound and persuasive fashion. To avoid needless expansion of these remarks, I incorporate herein the analysis of the panel majority by reference so far as pertinent here. Were they less convincing than they are—unless plainly wrong

—our respect for *stare decisis* and our dislike for going into conflict with another court should have carried the day. The objectionable consequences of conflicting lines of decisions in Federal tax cases are fully set forth in the *Preliminary Report of the Commission on Revision of the Federal Court Appellate System*, App. IV. This deals with the "Relitigation Policy" attributed to defendant, but relitigation by diverse taxpayers pursuing a common scheme or plan of tax avoidance is just as objectionable.

Defendant, with the authority of the Seventh Circuit behind it, would "impute" to plaintiff reserves under H & A policies it has arranged to have ostensibly carried for it by others, though in reality it bears the risk of loss itself. When such reserves are so "imputed" the plaintiff fails to pass the 50% test and is not entitled to the special advantages enjoyed by life insurance companies. As the Seventh Circuit shows, non-imputation completely frustrates the purpose Congress has in mind in prescribing the test. The contrary view is simply another instance of stating: "we see what you mean, Congress, but you said it wrong." To a simple, uncomplicated mind, the imputation is fully justified by the ancient maxim: "*Qui facit per alium, facit per se.*" Plaintiff maintains the reserves for purposes of the 801 (a) test, though for no other purposes, because it has arranged, itself or through its affiliates, and using the economic leverage they jointly possess, to have these reserves available to satisfy the right the H &

A policy holders possess to have their risks covered by legally acceptable reserves.

FINDINGS OF FACT

The court, having considered the evidence, the decision and findings of Trial Judge Lloyd Fletcher, and the briefs and arguments of counsel, makes findings of fact as follows:

General Background

1. Plaintiff was incorporated on August 8, 1955, under the statutes of the State of Missouri applicable to the organization of life insurance companies. It is empowered by its Articles of Incorporation and authorized by the insurance authorities of the State of Missouri to engage in the business of issuing contracts insuring or reinsuring against death or disability, and has carried on such business exclusively.

2. Plaintiff is a wholly owned subsidiary of ITT Aetna Corporation, a second tier subsidiary of International Telephone and Telegraph Corporation (IT&T). Prior to August 31, 1964, plaintiff's capital stock was owned by the Aetna Finance Company. On that date, Aetna Finance Company sold all of its assets (including plaintiff's stock) to IT&T, which subsequently transferred those assets to ITT Aetna Corporation as a contribution to capital. (References made hereafter to "Aetna" refer either to Aetna Finance Company and its subsidiaries (other

than plaintiff) or ITT Aetna Corporation and its subsidiaries (other than plaintiff) as appropriate.) Aetna has at all relevant times been engaged in the business of making consumer loans through subsidiaries which, during the years in issue, operated over 200 finance company offices in approximately 25 states.

3. Plaintiff was originally incorporated under the name American Universal Life Insurance Company, and operated under this name during the years in issue. Its name was changed to ITT Life Insurance Company in 1966, to ITT Hamilton Life Insurance Company in 1967, and finally to Penn Security Life Insurance Company on December 29, 1972.

4. Plaintiff's principal business, until approximately 1966, consisted of reinsuring death and disability risks underwritten by unrelated insurance companies in respect of credit life insurance policies issued by those companies to Aetna and its loan customers. By 1967, plaintiff's volume of business increased to the point at which it became more profitable for it to write its own credit insurance policies than to reinsure other companies. Plaintiff today writes a complete portfolio of the standard forms of ordinary and term insurance contracts including individual and group life, accident and health, and surgical coverage, as well as credit insurance for borrowers and installment purchasers.

5. Credit life insurance is usually sold as part of another and more prominent transaction, namely, a loan of money or an installment sale of tangible

personal property. Its primary function is to provide a sure, quick, and uncomplicated means for liquidating the balance due on the loan or installment sale in the event of the death of the borrower or purchaser and, where health and accident coverage is combined with credit life insurance to also pay the borrower's monthly installment while he is unable to work. It is generally written for a term which is coextensive with the contractual term of the related indebtedness. Occasionally a company may write a credit insurance policy with a term of as long as 5 years, but the average in the industry is two to three years in most instances.

6. Credit insurance may be written under an individual insurance policy issued directly to the insured debtor, or under a group policy, in which case the beneficiary-creditor is the policy holder and the individual insured debtor simply receives a certificate of insurance as evidence of coverage under the group policy. In either case, the creditor is the primary beneficiary to the extent of the unpaid balance of the indebtedness at the time of the insured debtor's death or disability.

7. Most of the credit insurance policies issued to Aetna and its loan customers during the years in issue (1963, 1964, and 1965) were written by three insurance companies: Old Republic Life Insurance Company of Chicago, Illinois (Old Republic), Pilot Life Insurance Company of Greensboro, North Carolina (Pilot), and National Fidelity Life Insurance Company of Kansas City, Missouri (National Fi-

delity). (Old Republic, Pilot, and National Fidelity are hereinafter sometimes referred to as "the ceding companies"). To a much lesser extent, credit insurance policies were also issued to Aetna and its loan customers by Insurance City Life Company (Insurance City) and the American Bankers Life Assurance Company of Florida (American Bankers). Plaintiff had reinsurance agreements or "treaties" in force with each of the above companies during the years in issue.

8. All credit life insurance policies and certificates issued by the ceding companies to Aetna and its loan customers provided for the payment of the entire premium (including the disability premium where accident and health coverage was included in the policy or certificate) at the inception of the policy term. When a disability premium under a single premium policy is first paid by the insured, it is wholly "unearned," in the sense that the entire premium is attributable to the unexpired portion of the policy. As the term of the policy expires with the passage of time, a proportionate part of the premium becomes "earned;" *i.e.*, attributable to insurance protection provided during the expired portion of the policy.

9. Unlike insurance such as fire, public liability, and similar types of casualty insurance, credit life insurance contracts, including those reinsured by plaintiff (both with and without disability benefits), cannot be canceled by the insurer during the term for which they are written. However, the policies

issued by the ceding companies to Aetna and its loan customers typically provided that insurance thereunder would terminate prior to the end of the term of the policy (usually, the maturity date of the indebtedness): (1) by renewal, refinancing, or repossession of the collateral for the indebtedness in connection with which the insurance was issued, (2) upon discharge of such indebtedness by payments by or on behalf of the debtor to the creditor, (3) by the indebtedness or any portion thereof being charged off or being required to be charged off by the laws applicable to the creditor, and (4) by cancellation of the insurance by the insured debtor. Under any of these circumstances, the policy typically provided for a refund of the unearned portion of premiums paid by the insured debtor in accordance with a prescribed formula, usually the Rule of 78.

10. Under the Rule of 78 or "sum-of-the-digits" method, the unearned premium is computed by applying changing fractions each year (or month, if unearned premiums are determined monthly) to the premium paid by the insured. The numerator of the fraction changes each year (or month) to a number which corresponds to the sum of the digits of the remaining unexpired term (years or months) of the policy, and the denominator, which remains constant, is the sum of all the years' (or months') digits corresponding to the entire term of insurance coverage. For example, if an insured debtor paid a $300 premium for disability benefits at the inception of

a three-year single premium policy, he would be entitled to a refund under the Rule of 78 of $300 $\left(\frac{3+2+1}{3+2+1}X\$300\right)$ if the policy was terminated at the beginning of the first year, $150 $\left(\frac{2+1}{3+2+1}X\$300\right)$ if the policy was terminated at the beginning of the second year, and $50 $\left(\frac{1}{3+2+1}X\$300\right)$ if the policy was terminated at the beginning of the third year.

11. The casualty insurance industry has historically viewed the unearned premium reserve as that portion of premiums paid by policyholders that is attributable to the unexpired terms of outstanding policies and that would have to be refunded to policyholders if all policies in force were to be canceled as of the statement date. The concept of an unearned premium serves several functions with respect to accident and health insurance. Primarily, the unearned net premium represents funds that must be held to provide the cost of the insurance risk which has not yet expired porportionate to the period for which premiums have been paid in advance. Unearned loading charges, which are obtained by subtracting the unearned net premium from the total unearned gross premium reserve, constitute a solvency reserve for the payment of refunds and future expenses. Unearned premium reserves maintained by the ceding companies on credit accident and health insurance covering debtors of Aetna were computed under the Rule of 78 method,

the same method normally used in determining the required refund to policy holders in the event of a premature termination of a policy. One result of including unearned loading charges in the unearned gross premium reserve is a heavy charge to surplus which sometimes prevents the ambitious or over-rapid expansion of a company that might well result in its ultimate insolvency. Another result is that it imposes in an indirect manner additional capital requirements on companies having larger amounts of business in force.

12. Generally speaking, where insurance coverage is provided, the premium payable by the insured under the policy is due and payable at the outset of coverage. Whether this requirement obtains as between a ceding company and its reinsurer company depends on the provisions of the reinsurance treaty between them.

13. More than half of the dollar value of benefits reinsured by plaintiff during the years in issue under its treaties with the above companies were life insurance benefits. Some of the policies covered under plaintiff's reinsurance treaties were credit life insurance policies providing only death benefits. The remaining policies were credit life insurance policies combined with accident and health coverage, but the latter coverage never exceeded the amount of life insurance benefits provided under the policy (normally, the amount of the loan). With but one exception, none of the covered policies provided only credit accident and health insurance.

The Life Insurance Company Issue

14. For each of its taxable years ended December 31, 1963, 1964, and 1965, the mean of plaintiff's life insurance reserves at the beginning and end of each year comprised more than 50 percent of the mean of its total reserves at the beginning and end of each year, as such reserves were reported on the annual statements submitted by plaintiff to the Missouri Division of Insurance and on the income tax returns filed by plaintiff for those years. The ratio of plaintiff's life insurance reserves to its total reserves under plaintiff's view of the case and as computed on its income tax returns for 1963, 1964, and 1965 were as follows:

	Jan. 1, 1963	Dec. 31, 1963	Mean
Life Insurance Reserves	$556,923.00	$733,027.00	$644,975.00
Total Reserves	790,108.00	1,092,918.49	941,513.28
Reserve Test Ratio (1÷2)			68.50%
	Jan. 1, 1964	Dec. 31, 1964	Mean
Life Insurance Reserves	733,027.00	806,698.00	769,862.50
Total Reserves	1,092,918.49	1,733,125.97	1,413,022.23
Reserve Test Ratio (1÷2)			54.48%
	Jan. 1, 1965	Dec. 31, 1965	Mean
Life Insurance Reserves	806,698.00	7,037,233.00	3,921,965.50
Total Reserves	1,733,125.97	7,413,108.58	4,573,117.28
Reserve Test Ratio (1÷2)			85.76%

15. The determination of the Commissioner of Internal Revenue that plaintiff was not a "life insurance company" as defined in Section 801 of the Code in 1963, 1964, and 1965 was based upon his inclusion in plaintiff's "total reserves" of unearned gross premiums actually held by the ceding companies (*i.e.* Old Repub-

lic, Pilot, and National Fidelity) in respect of disability benefits under credit life insurance policies (combined with health and accident insurance) issued by those companies to Aetna and its loan customers. The amounts of "unearned premiums" added by the Commissioner of Internal Revenue to plaintiff's "total reserves" as of December 31, 1962, 1963, 1964, and 1965 were as follows:

Unearned Premiums Attributed to Plaintiff

From	Dec. 31, 1962	Dec. 31, 1963	Dec. 31, 1964	Dec. 31, 1965
Old Republic	$183,342	$147,375	$145,833	$191,416
Pilot	728,821	782,726	724,445	829,480
National Fidelity	413,973	495,288	570,083	773,670
Total	1,326,635	1,425,389	1,440,351	1,794,566
	[*sic* 1,326,136]			

The Government now concedes that unearned premiums under the Old Republic Disability Reinsurance Treaty are not attributable to taxpayers for purposes of qualification as a life insurance company.

16. The unearned premiums attributed to plaintiff by the Commissioner of Internal Revenue as of December 31, 1962, 1963, 1964, and 1965 were actually held by the ceding companies on those dates and were included in the unearned premium reserves shown on the annual statements which they submitted to the insurance authorities of the various states in which they did business. In recognition of their continuing obligations to their policyholders, the ceding companies were required, both from an actuarial standpoint and under state law, to establish such unearned premium reserves while they actually held the unearned premiums in order to have funds

available to pay claims and refunds to their policyholders and to reflect the fact that they had received premiums from policyholders for insurance protection to be provided after the statement date. The annual statements of those companies, in which the unearned premiums which the Commissioner of Internal Revenue now seeks to include in plaintiff's reserves were shown as unearned premiums of the ceding companies, were accepted by the insurance authorities in all the states in which the ceding companies did business.

The ceding companies maintained the unearned premiums attributed to plaintiff along with their other reserve funds in accordance with the applicable restrictions of state law, and they received the proceeds from their investments of such funds (interest, dividends, etc.) as their own income. Plaintiff did not obtain or use the unearned premiums reflected in the annual statements of the ceding companies, nor were such unearned premiums credited, set apart or made available to plaintiff. None of the ceding companies was owned or controlled, directly or indirectly, by plaintiff, Aetna, or IT&T.

17. The health and accident portion of the combined policies or certificates issued in connection with group policies were entirely separate insurance contracts which set forth a separate health and accident premium. However, it has been stipulated that credit accident and health insurance was never in fact sold without credit life insurance coverage and, except in one state, the two coverages were never sold as sepa-

rate contracts. The life insurance reserves maintained by taxpayer on the life coverage were calculated without regard to any health and accident coverage written in combination therewith; conversely, the ceding companies ignored any combined life insurance coverage when they calculated and set up unearned premium reserves on the health and accident coverage.

18. Plaintiff had separate reinsurance treaties covering life insurance risks and disability insurance risks with each of the ceding companies during the years in issue. Under the disability reinsurance treaties, plaintiff agreed to reinsure 100 percent of the liability of each ceding company with respect to disability benefits included in credit life insurance policies issued to Aetna and its loan customers. The treaties provided for payment of a monthly reinsurance premium equal of 98 percent (89 percent under the Old Republic treaty) of the premiums earned with respect to credit accident and health insurance in force during the previous month. The following excerpts from the Pilot treaty are typical:

Article I.

> * * * Pilot Life agrees to reinsure with [Taxpayer] one hundred per cent (100%) of the total of all Credit Accident and Health issued by Pilot Life covering the debtors of Aetna Finance Company. * * *, and [Taxpayer] agrees to accept such reinsurance automatically.

Article II.

> 1. The liability of [Taxpayer] on all reinsurances shall begin simultaneously with that

of Pilot Life and in no event shall the reinsurance of [Taxpayer] be in force and binding unless the policy issued by Pilot Life is in force.

2. In all reinsurances the liability of [Taxpayer] shall cease when the liability of Pilot Life ceases.

* * * *

Article III.

1. Reinsurance payments to [Taxpayer] shall be made on or before the twenty-fifth of each calendar month, on a monthly term basis, based on all accident and health insurance in force during the previous month on policies reinsured with [Taxpayer].

2. The premium payable in any month shall be ninety-eight per cent (98%) of the earned premiums the previous month for all accident and health policies reinsured hereunder. Earned premiums for any month on such policies are all premiums written during such month, less returned premiums on such policies during such month, plus unearned premium reserves on such policies at the beginning of the month, and less the unearned premium reserves on such policies at the end of such month.

3. From the reinsurance premium due [Taxpayer] shall be deducted and withheld by Pilot Life:

A. The following expenses which are assumed by [Taxpayer]:

(1) All premium, occupational and privilege taxes applicable to the insurance.

(2) The cost of policy forms.

(3) Any special claim expense incurred by Pilot Life in accordance with Section 3 of Article IV hereof, and

(4) Any commissions paid to or retained by agents for writing the insurance; and

B. The total of all claims paid under reinsured policies during the period for which the premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the earned premium for the period covered, [Taxpayer] shall pay to Pilot Life the amount of such excess upon receipt of a statement of the amount of such excess.

5. If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to [Taxpayer] for payment of monthly reinsurance premiums until all premiums on policies reinsured with [Taxpayer] prior to the termination have been earned, and [Taxpayer] shall nevertheless be liable to Pilot Life for payment of all claims arising out of policies reinsured with [Taxpayer] prior to the termination. After all reinsurance premiums have been paid, [Taxpayer] shall pay Pilot Life the amount of any claims on such reinsured policies, which claims were paid by Pilot Life and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims.

Article IV.

1. [Taxpayer] shall be liable to Pilot Life for the benefits covered by reinsurance hereunder to the same extent as Pilot Life is liable to the persons insured for such benefits and all reinsurance shall be subject to the terms and con-

ditions of the policy under which Pilot Life is liable.

2. Whenever a claim is made under a policy that Pilot Life reinsured under this agreement, it shall be considered by [Taxpayer] to be a claim for the full amount of reinsurance on such policy and [Taxpayer] shall abide by the settlement made by Pilot Life and shall pay the full amount of reinsurance.

3. Any suit or claim may be tested or compromised on the part of Pilot Life and in case of reduction of the claim made upon Pilot Life, the claim made upon [Taxpayer] shall be reduced accordingly. Any special expense incurred by Pilot Life in defending or investigating any claim shall be borne by [Taxpayer].

19. Plaintiff's disability reinsurance treaties with the ceding companies fell into the category of "reinsurance ceded"; *i.e.*, they were solely contracts of insurance between two insurance companies (the "ceding company" and the "reinsurer"), and did not create any contractual obligation running from the reinsurer (plaintiff) to the policyholders of the ceding companies. Such reinsurance did not relieve the ceding companies of contractual liabilities to their policyholders, e.g., the obligation to pay benefits and to refund unearned premiums in the event of cancellation or other termination of a policy before the expiration of its full term. Consequently, the mere fact that the ceding companies obtained reinsurance from plaintiff under these treaties did not affect their responsibility, under state law or under actuarial principles, to set up an unearned premium reserve to

reflect the unearned premiums actually held by those companies or policies covered by reinsurance treaties with plaintiff. Ceding companies, however, may obtain a credit on their annual statement forms for unearned premium reserves actually transferred to a reinsurer since, as explained by plaintiff's expert, the liability for an unearned premium reserve "depends on whether you've got the money or not * * *."

20. An unearned premium reserve measures an insurance company's reserve requirements by looking to premiums already paid by policyholders and then determining the portion of such premiums that represent payment for insurance to be provided after the statement date. Plaintiff was not required to establish an unearned premium reserve with respect to its reinsurance of the ceding companies because, as of each statement date, no portion of the reinsurance premiums received and held by plaintiff represented payment for insurance to be provided after the statement date; *i.e.*, all such reinsurance premiums were fully earned.

21. Life insurance reserves may be measured prospectively as the difference between the present value of future claims expected to be paid and the present value of premiums to be received. Even if this prospective test had been applied to plaintiff's disability reinsurance treaties with the ceding companies, under any reasonable assumption as to future claims, the present value of reinsurance premiums to be received under such treaties exceeded the present value of probable claims. Thus, measured either retrospectively or prospectively, plaintiff did

not have any reserve obligation under its treaties with the ceding companies.

22. Plaintiff had no contingent obligation to refund reinsurance premiums received from the ceding companies since it received such premiums only after they had been fully earned. Nor did plaintiff have any obligation to refund premiums paid by policyholders of the ceding companies in the event of cancellation or other premature termination of policies issued by the ceding companies. Consequently, there was no need for plaintiff to establish an unearned premium reserve for the purpose of maintaining a fund available for the refund of premiums.

23. Plaintiff also had a reinsurance treaty in force during the years in issue with Insurance City, which treaty covered both death and disability risks under credit life insurance policies issued by Insurance City to Aetna and its loan customers in the State of Rhode Island. All of the credit life insurance policies issued by Insurance City to Aetna and its loan customers (including those with disability benefits) provided for the payment of single premiums at the inception of the policy term on both life and accident and health coverages. Under its reinsurance treaty with Insurance City, plaintiff was entitled to receive the full disability premium collected by Insurance City for the entire policy term on policies covered under the treaty, less 10 percent of such premiums retained by Insurance City, in the month following receipt by Insurance City. Such reinsurance premiums were paid for reinsurance for the entire term

of policies issued by Insurance City to Aetna and its loan customers during that month, and not merely for reinsurance actually provided by plaintiff during such month. Therefore, plaintiff maintained unearned premium reserves with respect to that portion of premiums received from Insurance City which represented payment for reinsurance to be provided in the future.

24. The insurance business is regulated by the states. For example, the state insurance departments supervise policy forms, agency relationships, investments, accounting practices, reserves, and the general financial responsibility of insurance companies. State law and/or regulations direct insurance companies to set up reserves that are designed to preserve the solvency of those companies for the protection of policyholders.

25. For each of the years 1962, 1963, 1964, and 1965 plaintiff filed an annual statement with the Missouri Division of Insurance on the form prescribed by the National Association of Insurance Commissioners for life and accident and health companies. The annual statement is a record of the income and disbursements of an insurance company during the year on an accrual basis, as well as a balance sheet which reflects the solvency of the reporting insurance company at the end of the accounting period. The calendar year is the prescribed accounting period of all life insurance companies, including plaintiff.

26. Plaintiff's annual statements for the years

1962, 1963, 1964, and 1965 did not reflect any unearned premium reserves with respect to policies issued by Old Republic, Pilot, and National Fidelity, or with respect to plaintiff's reinsurance treaties with those companies. The only unearned premium reserves reflected on plaintiff's annual statements for the above years were unearned premium reserves relating to plaintiff's reinsurance treaty with Insurance City.

27. State insurance authorities monitor the adequacy of the reserves held by insurance companies within their jurisdictions by reviewing the annual statements submitted by those companies and by conducting a comprehensive audit at least once every three or four years. The examination includes a verification and evaluation of assets, the establishment of liabilities, and a general review of other records and procedures including the contracts and policies in force at the valuation date. If an insurance company did not properly report its liabilities as of the valuation date under examination, the examiners would recompute such liabilities in accordance with actuarial standards and governing state law and regulations.

28. Plaintiff was audited by the Missouri Division of Insurance in 1965 for the period from September 30, 1961, through December 31, 1964. Plaintiff was also audited in 1969 with respect to the period from January 1, 1965, through December 31, 1968, by the Missouri Division of Insurance with participation by examiners from the States of Mary-

land, Wyoming, and California. There was attached to the report of examination for the period September 30, 1961, through December 31, 1964, a statement from the consulting actuaries of plaintiff as follows:

> As Consulting Actuaries who aided in the preparation of the December 31, 1964 Financial Statement of American Universal Life Insurance Company, [now ITT Hamilton] we affirm that we determined the policy reserves listed below, and that the amounts thereof were computed in accordance with the terms of the outstanding policies and the Insurance Code of the State of Missouri, and that, based upon the records of the Company furnished to us, they are a true statement of the reserve liabilities of the Company as of December 31, 1964.
>
> 1. Aggregate Reserve for Life Policies $806,698.00
>
> 2. Aggregate Reserve for A. & H. Policies 59,673.48

29. The Missouri Division of Insurance did not require plaintiff to establish unearned premium reserves with respect to premiums received by the ceding companies for disability benefits provided by those companies under policies issued to Aetna and its loan customers or with respect to reinsurance premiums received by plaintiff under its disability reinsurance treaties with such companies. According to plaintiff's expert witness, no state regulatory authority would impose an unearned premium reserve requirement on an insurance company where, as

under plaintiff's disability reinsurance treaties with the ceding companies, such company did not receive premiums for insurance to be provided in the future.

30. The premium charge for a life insurance contract is computed so as to cover all the contingencies the insurance company is likely to meet, and these contingencies are generally grouped into three elements, namely, mortality, interest, and "loading" (*i.e.*, profit and expenses). Mortality refers to that part of the premium which provides for the occurrence of the risk insured against while the second element takes into account the assumed interest to be earned by the company. The third element primarily covers profit and the cost incident to management of the company, such as salaries, rents, commissions, taxes, and other costs of doing business. In arriving at a premium charge, the first and second step is the computation of what is called a "net premium" which takes into account only the mortality and interest elements. To the net premium is then added an amount called "loading" which is calculated to provide for profit and expenses. The resulting premium, called the "gross premium," is the premium charged to the policyholder.

31. The premium charge for accident and health insurance coverage is computed similarly to a life insurance premium, except that the mortality element of a life insurance premium is replaced by the 'morbidity" element of the accident and health premium (*i.e.*, that part of the premium which provides for the occurrence of the *risk* of the insured becoming disabled because of accident or sickness).

32. Unearned premium reserves on casualty (including accident and health) insurance have traditionally been computed on an unearned *gross* premium basis; *i.e.*, the reserve is calculated as a portion of the entire premium received from the policyholder, including the portion charged to cover expenses and profits ("loading"). The computation of unearned premium reserves on an unearned gross premium basis stems from the historic practice of maintaining unearned premium reserves equal to the aggregate amount of premiums that would have to be refunded if all outstanding policies were canceled. However, the cost of carrying the insurance risk on an accident and health policy is the unexpired portion of the *net* premium charged to the policyholder. That part of the unearned premium reserve which represents the unexpired portion of the "loading" charge is not a true insurance reserve at all, but rather a solvency reserve or reserve for future expenses which in effect requires the reserving company to segregate part of its surplus until the policy has expired.

Life insurance reserves, in contrast to unearned gross premium reserves, are "risk only" reserves and do not include any portion of the loading charge made to the policyholder.

33. The unearned premium reserves of the ceding companies attributed to plaintiff were calculated on an unearned *gross* premium basis. As stipulated by the parties, the following "tabular morbidity reserves" represent the total "net premium" (*i.e.*,

morbidity) element in the unearned gross premium reserves held by the ceding companies (including Old Republic) with respect to disability benefits included in credit life insurance policies issued by the ceding companies to Aetna and its loan customers:

Date	Total Tabular Morbidity Reserves
December 31, 1962	$434,213
December 31, 1963	503,279
December 31, 1964	559,401
December 31, 1965	652,489

However, in view of defendant's concession that no unearned premiums (either net or gross) may be attributed to plaintiff from Old Republic (see finding 15, *supra*) the "net premiums" or "tabular morbidity reserves" in this paragraph have been restated by plaintiff's actuary so as to remove "net premiums" held by Old Republic. Mr. E. Dean Forbes, A.S.A., the actuary who computed the original tabular morbidity reserves appearing in paragraph 57 of the Stipulation of Facts has made this recomputation, removing net premiums held by Old Republic, and leaving only net premiums held by Pilot, National Fidelity, and plaintiff (under its Insurance City treaty).

In accordance with said recomputation, it is found that the following "Tabular Morbidity Reserves" represent the total "net premium" (*i.e.*, morbidity) element in the unearned gross premium reserves reflected on the annual statements of Pilot, National Fidelity, and plaintiff (under the Insurance City Reinsurance Treaty) on December 31, 1962, 1963,

1964, and 1965, respectively, with respect to credit accident and health insurance issued to loan customers of Aetna and its subsidiaries:

Date	Total Tabular Morbidity Reserves
December 31, 1962	$378,238
December 31, 1963	438,390
December 31, 1964	494,819
December 31, 1965	575,216

The above "Tabular Morbidity Reserves" were computed on the basis of the 1964 Commissioners' Disability Table, a recognized morbidity table approved by the National Association of Insurance Commissioners.

34. Plaintiff qualifies as a "life insurance company" within the meaning of Section 801 of the Code for the years 1963 and 1965, even if unearned premium reserves of the ceding companies on disability benefits included in credit life insurance policies issued to Aetna and its loan customers are added to plaintiff's "total reserves" for those years, if the attributed reserves are calculated on a *net* basis. Plaintiff also qualifies as a life insurance company for the year 1964 if attributed reserves are calculated on a *net* basis assuming, however, that plaintiff is entitled to included unpaid losses on credit life insurance in both the numerator and denominator of the life insurance company qualification formula in that year.

Plaintiff's qualification ratio for each of the years in issue, based on a "net premium" attribution, is as follows:

Plaintiff's Qualification Ratios Assuming Attribution of Net Premiums from Pilot and National Fidelity

	Jan 1, 1963	Dec. 31, 1963	Mean
Life Insurance Reserves	$556,923	$733,027	$644,975
Total Reserves	1,036,028	1,302,649	1,169,338
Qualification Ratio (1÷2)			55.1%
	Jan. 1, 1964	Dec. 31, 1964	Mean
Life Insurance Reserves	733,027	806,698	769,863
Total Reserves	1,302,649	1,873,862	1,588,255
Qualification Ratio (1÷2)			48.4%
	Jan. 1, 1965	Dec. 31, 1965	Mean
Life Insurance Reserves	806,698	1,626,902	1,216,800
Total Reserves	1,873,862	2,305,514	2,089,688
Qualification Ratio (1÷2)			58.2%

35. Those credit life insurance policies issued by the ceding companies to Aetna and its loan customers which included disability benefits are sometimes referred to in the insurance industry as life insurance contracts combined with accident and health insurance. They are conceptually identical to combined life, health and accident insurance contracts issued by insurance companies since the early part of this century, which provide payment of the face amount of policies in the event of death, or, if the insured becomes disabled, of installments of the face amount over a period of years.

36. The terms "cancellable" and "noncancellable" have definite and specific meanings in the insurance industry. The National Association of Insurance Commissioners has defined the term "noncancellable" as follows (NAIC, Report to the National Association of Insurance Commissioners Subcommittee on Definition of Non-Cancellable Insurance and Guaranteed Renewable Insurance 156 (1960):

> The terms "noncancellable" or "noncancellable and guaranteed renewable" may be used only in a policy which the insured has the right to continue in force by the timely payment of premiums set forth in the policy (1) until at least age 50, or (2) in the case of a policy issued after the age 44, for at least 5 years from its date of issue, during which period the insurer has no right to make unilaterally any change in any provision of the policy while the policy is in force.

Some accident and health policies are written for the life of the insured at a guaranteed annual premium. A reserve in addition to the unearned premium reserve must be maintained on such policies as a consequence of charging a premium for a benefit that costs increasingly more to provide as the insured grows older. This additional reserve is accumulated from premium payments and interest earnings that will not be needed to pay claims arising during the current policy year of the contract. The reserve is computed on the basis of recognized morbidity tables at an assumed rate of interest. An additional reserve is also required where the policy is written for some term which is shorter than the insured's life where the premium charged provides a benefit that costs increasingly more to provide as the insured grows older. Neither Old Republic, Pilot, nor National Fidelity maintained an additional reserve in addition to the unearned premium reserve with respect to credit accident and health insurance covering debtors of Aetna and its subsidiaries.

Although there is no analogy in life insurance to the unearned gross premium reserve required in casualty insurance, a life insurance reserve may be roughly compared with the unearned *net* premium element in the unearned premium reserve because both are computed on the basis of the actuarial cost of carrying the risk.

Plaintiff's Group Annuity Policy No. 101

37. On December 22, 1965, plaintiff issued Group Annuity Contract No. 101 to the St. Louis Union Trust Company as Trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees, which contract has remained outstanding and in effect to the present time. On or about December 22, 1965, plaintiff received securities valued at $5,929,057.24 from the St. Louis Union Trust Company for the purchase of single premium annuities for certain retired individuals covered by the International Telephone Retirement Plan for Salaried Employees which obligated plaintiff to pay annuities to such retired individuals (and their spouses, in some cases) under the terms of Group Annuity Contract No. 101. Prior to this transaction, no group annuity or individual annuity contracts had been purchased by IT&T, the St. Louis Union Trust Company, or any Trustee of any pension fund existing under the International Telephone Retirement Plan for Salaried Employees from any insurance company or other person on the lives of the individuals covered under Group Annuity Contract No. 101.

38. Plaintiff maintained a reserve of $6,072,004 on December 31, 1965, with respect to its liabilities under Group Annuity Contract No. 101 on that date. Such reserve was computed on the basis of a recognized mortality table (1951 G.A.) and an assumed rate of interest (3½%), and was set aside to mature or liquidate future unaccrued claims arising under Group Annuity Contract No. 101.

Deficiency Reserves

39. The accepted definition of a deficiency reserve in the insurance industry is the amount by which the present value of the future premiums required (by statute) for a life insurance or annuity contract exceeds the present value of the future premiums and consideration actually charged for such contract.

40. By definition, there can be no deficiency reserve requirement with respect to a life insurance or annuity contract once all premiums called for under such contract have been paid. Thus, there can never be a deficiency reserve required with respect to a single premium life or annuity policy under which the entire premium is payable at the inception of the policy. All of the life and annuity policies reinsured or issued by plaintiff during the years in issue were single premium policies of this type. On an ordinary whole life insurance policy, the deficiency reserve required at the inception of the policy, if any, gradually diminishes as premiums are received by the company. Defendant now concedes this issue.

History of the Controversy

41. For each of the years 1963, 1964, and 1965, plaintiff timely filed with the District Director of Internal Revenue at St. Louis, Missouri, a Federal income tax return on Treasury Form 1120L, U.S. Life Insurance Company tax return, and computed its taxable income and tax as a life insurance company according to Section 802 of the Code. The tax shown to be due on the returns filed for those years, as reported in the table below, was paid in full.

Year	Tax Shown to be Due on Plaintiff's Return
1963	$479,356.02
1964	377,217.70
1965	467,266.14

42. On August 18, 1967, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, claims for refund of income taxes previously paid in respect of the years 1963, 1964, and 1965 (hereinafter referred to as the 1967 claims) in the following amounts:

Year	Amount Claimed	
1963	$156,148.50	(or $143,737.56 in the alternative)
1964	140,482.78	
1965	47,252.76	

Neither the Secretary of the Treasury nor his delegate having theretofore rendered a decision on the 1967 claims, plaintiff, on April 4, 1968, filed suit for a refund of such income taxes in this court.

43. On October 24, 1968, after plaintiff had filed a petition claiming a refund of income taxes paid in

respect of the years 1963, 1964, and 1965 in this court, and prior to a hearing of plaintiff's claims, the Commissioner of Internal Revenue determined deficiencies in plaintiff's income tax for the years 1963, 1964, and 1965 in the following amounts:

Year	Deficiency
1963	$337,376.70
1964	362,986.20
1965	265,412.05

The asserted deficiencies were based upon a determination that plaintiff did not qualify as a life insurance company during the years 1963, 1964, and 1965 under Section 801(a) of the Code, but rather was taxable as an insurance company other than a life or mutual insurance company in those years.

44. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiencies within the time allowed by Section 6213(a) of the Code, or at any time thereafter. On February 14, 1969, the Commissioner of Internal Revenue assessed the amount of the asserted deficiencies in plaintiff's income tax for the years 1963, 1964, and 1965, together with interest on such deficiencies, and demanded payment thereof. Plaintiff contests the validity of this assessment. On March 5, 1969, the following amounts were paid to the District Director of Internal Revenue at St. Louis, Missouri, under protest, in respect of the deficiencies in plaintiff's income taxes assessed for the years 1963, 1964, and 1965, and interest thereon:

Year	Deficiency	Interest	Total
1963	$337,376.70	$99,747.96	$437,124.66
1964	362,986.20	85,540.43	448,526.63
1965	265,412.05	46,621.63	312,033.26

45. On April 21, 1969, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, claims for refund of the amounts assessed by the Commissioner of Internal Revenue on February 14, 1969, and paid by plaintiff on March 5, 1969, as additional income taxes, and interest thereon, for the years 1963, 1964, and 1965 (hereafter referred to as the 1969 claims). Plaintiff received a formal notice of disallowance of its 1969 claims from said District Director on December 3, 1969, and filed its First Amended Petition with this court on March 30, 1970, seeking recovery of income taxes with respect to both its 1969 and 1967 claims.

46. On May 8, 1969, defendant filed a motion with this court for leave to file an amended answer to plaintiff's petition. Defendant's motion was allowed and an amended answer was filed on July 8, 1969, which amended answer included a counterclaim alleging that the Commissioner of Internal Revenue had assessed additional income taxes and interest for the years 1963, 1964, and 1965 and demanded payment thereof and that such assessment had not been paid. Plaintiff filed a reply to defendant's counterclaim on August 12, 1969, alleging, *inter alia*, full payment of such additional taxes and interest.

47. In its Answer to plaintiff's First Amended Petition defendant stated that "since the Plaintiff has paid the taxes for which the counterclaim was filed

and amended its petition to include a claim for refund for these taxes, a counterclaim by the defendant is no longer necessary, nor required by law." Defendant's Answer to First Amended Petition, Count I ¶ 13(d), Count II, ¶ 11(d), Count III, ¶ 13(d), Count IV, ¶ 13(d).

Ultimate Finding of Fact

48. During each of the years 1963, 1964, and 1965, plaintiff was a life insurance company engaged in the business of issuing or reinsuring life insurance and annuity contracts (issued either separately or combined with accident and health insurance) and its life insurance reserves plus unearned premiums and unpaid losses on non-cancellable life, health or accident policies not included in life insurance reserves comprised more than 50 percent of its total reserves during each of those years within the meaning of Section 801 of the Internal Revenue Code of 1954.

CONCLUSION OF LAW

Upon the foregoing findings of fact which are made a part of the judgment herein, the court concludes as a matter of law that plaintiff is entitled to recover, and judgment is entered to that effect, with the determination of the amount of recovery to be made in further proceedings under Rule 131(c).

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